The Role Of Claims-Paying Ratings

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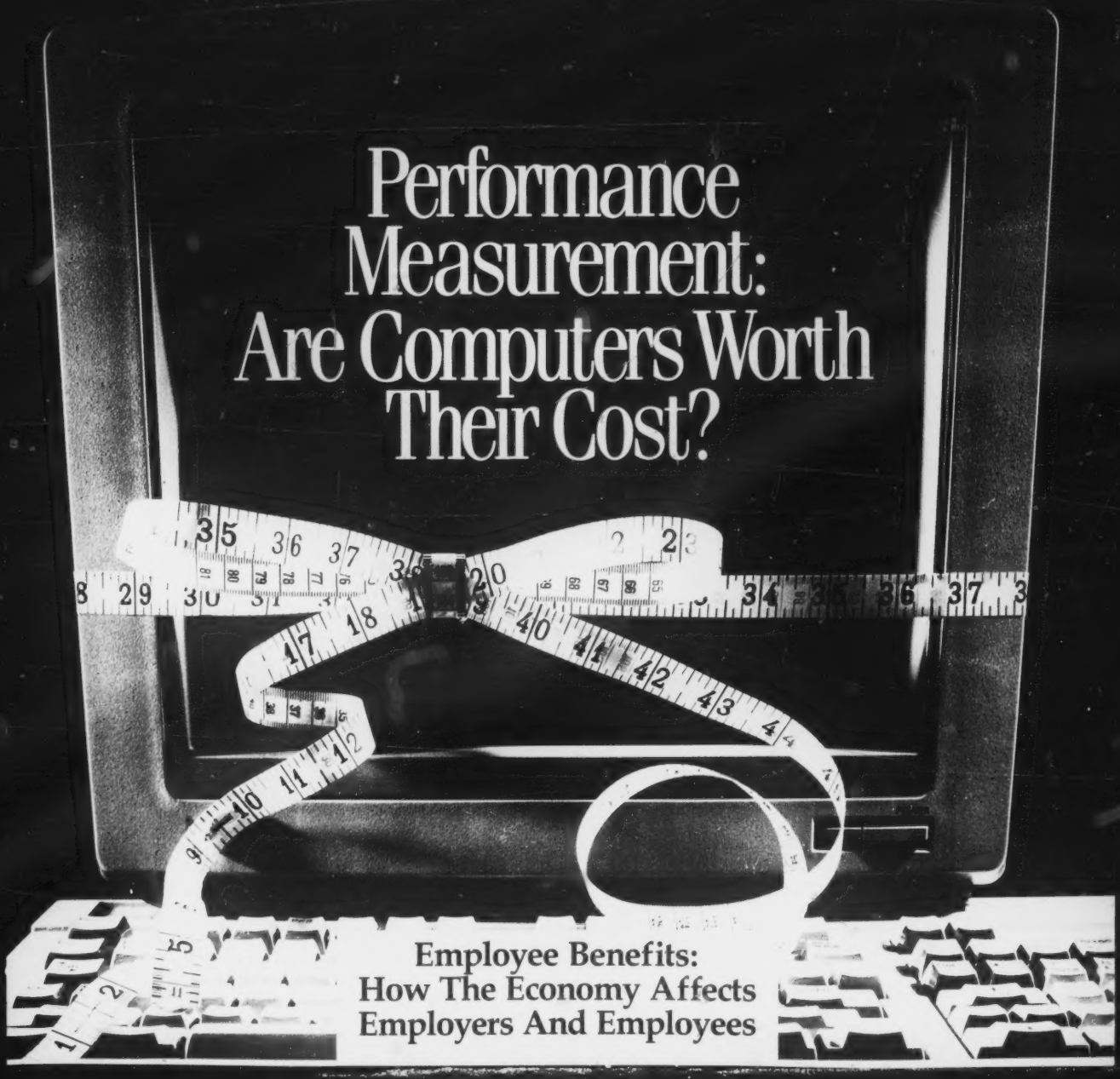

Performance Measurement: Are Computers Worth Their Cost?

Employee Benefits: How The Economy Affects Employers And Employees

Investment Managers • Plan Sponsors • Employee Benefits

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About The Cover: To increase productivity and measure performance, pension administrators are increasing their use of computers.

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How The Economy Affects Employers and Employees

Retirement benefits are directly related to wages and should maintain a steady relationship as wages respond to competitive pressures.

BY HERBERT V. KAIGHAN, Principal
Mercer Meidinger Hansen, Los Angeles

Many variables affect benefit costs. While some variables are direct economic elements—taxes, inflation and unemployment—others are indirect variables—demographics, legislation and judicial decisions.

Generally, benefit costs are measured against compensation, which closely follows the country's gross national product (GNP) and consumer price index (CPI). But non-retirement benefit costs, especially life and disability insurance and medical benefits, seem not to parallel general economic trends despite the fact that they have risen relative to the GNP. Indeed, 20 years ago, benefits equaled 12 percent of GNP. Today, benefits equal about 16 percent of GNP.

Through both highs and lows in the economy, benefit costs have skyrocketed during the past three decades. According to the U.S. Chamber of Commerce, overall benefit costs relative to compensation grew from 24 percent in 1959 to 39 percent in 1979, although these costs recently have declined to about 38 percent.

Overall, retirement benefits are directly related to wages and should maintain a steady relationship as wages respond to competitive pressures, technological advances and economic fluctuations. But if this is the case, why have non-retirement benefits grown faster than compensation?

Historically, the rationale has been an employer's desire to provide employees with a form of compensation that escapes taxes. As a result, a better benefits package—life and disability insurance, health care, added vacation and sick leave—has been an attractive alternative to wage increases.

Yet, four other factors are influencing the growth of non-retirement benefits: demographics, inflation, legislation and judicial decisions.

First, America's work force is getting older and living longer. Indeed, it is more expensive to provide health care for a population with older members.

Second, inflation has been part of the problem. Overall, health-care costs continue to spiral against the GNP—during recession and recovery.

Third, the history of benefit legislation reflects numerous attempts to fix the problems associated with health-care costs. The passage of Medicare in 1966 and the health maintenance organization (HMO) act in 1973 are prime examples. There has been a dramatic rise in medical costs since the enactment of Medicare, along with an avalanche of benefits legislation: ERISA, ERTA, TEFRA, REA, DEFRA, COBRA, TRAC and OBRA.

And fourth, the courts are having an ever-increasing impact on benefits, especially on the issue of retiree life and health.

As a result of these influences on non-retirement benefits, more death benefits are now available, with most programs being salary-related. Because of recent tax acts, today's plan design emphasizes keeping eligibility and benefits non-discriminatory in order to protect key employees' and retirees' $50,000 benefit exemption.

Additionally, the number of individuals covered under disability plans has more than doubled during the past 10 years. While the economy affects all disability plans, it especially affects long-term disability. A study conducted by Union Mutual revealed a marked parallel between the incidence rate (the number of claims per 1,000 employees) and

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inflation/unemployment. According to the study, the number of claims increases in periods of high inflation and high unemployment.

The economy also directly affects the cost of medical benefits. Currently, the cost of medical benefits accounts for 60 percent to 70 percent of a welfare-benefits program. As a percentage of GNP, health-care costs will rise to more than 11 percent in 1988 and are predicted to approach 14 percent of GNP by 1990.

Traditionally, awareness and cost-efficiency have been the bywords for benefit-plan design. Today, these concepts are causing radical change, especially in hospitalization. Employers are continually striving to control utilization, ensure quality and restrain costs through such mechanisms as utilization review, HMOs, preferred provider organizations (PPOs) and plan-design changes. Indeed, employers are requiring employee contributions and benefit cutbacks.

Until mid-1987, these efforts appeared to be paying off. However, during the past six months there appears to be a re-escalation in medical-benefit costs. The cost increases range from 25 percent to 55 percent, depending on geography, industry and plan design.

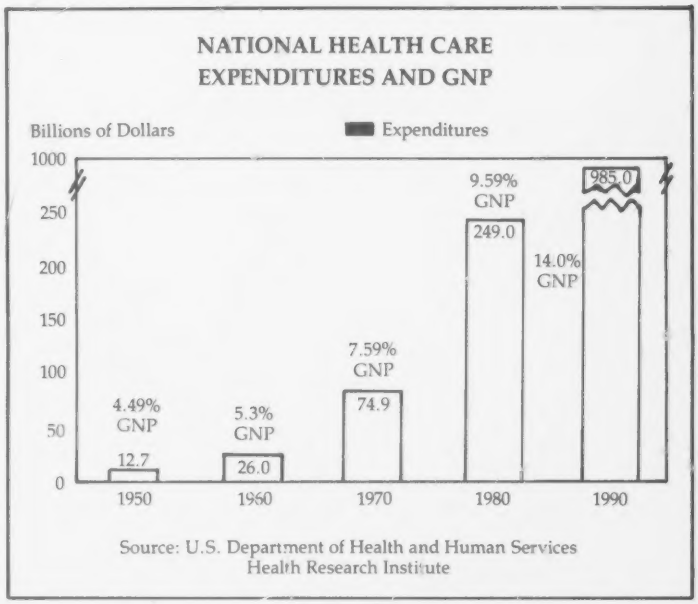
Although hospital occupancy and the average length of stay are falling, plan expenditures are increasing. Outpatient and home care are on the rise, while hospitals appear to be pricing themselves out of the routine health-care market. In fact, 10 percent of the nation's hospitals are expected to go bankrupt within the next few years.

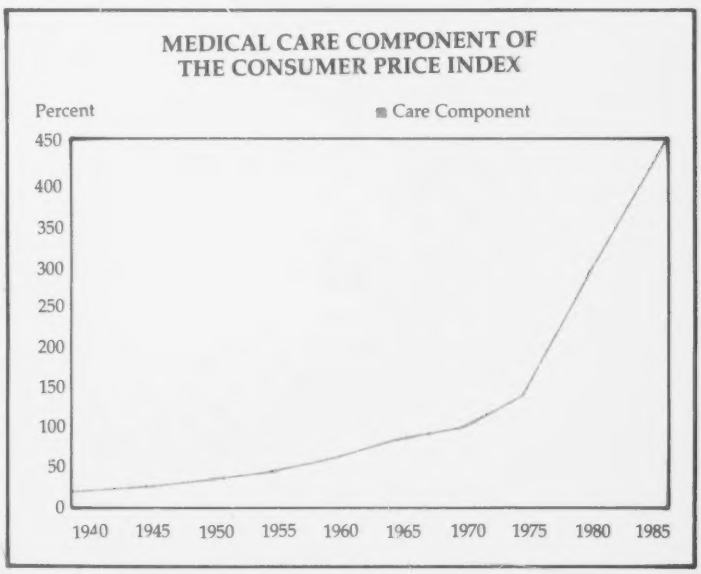
A Mercer Meidinger Hansen survey of chief executive officers of major American corporations on the health-care industry and health-care cost management found that the CEOs believe overwhelmingly that the country still faces a health-care crisis. But the CEOs believe this is a crisis of cost, not quality.

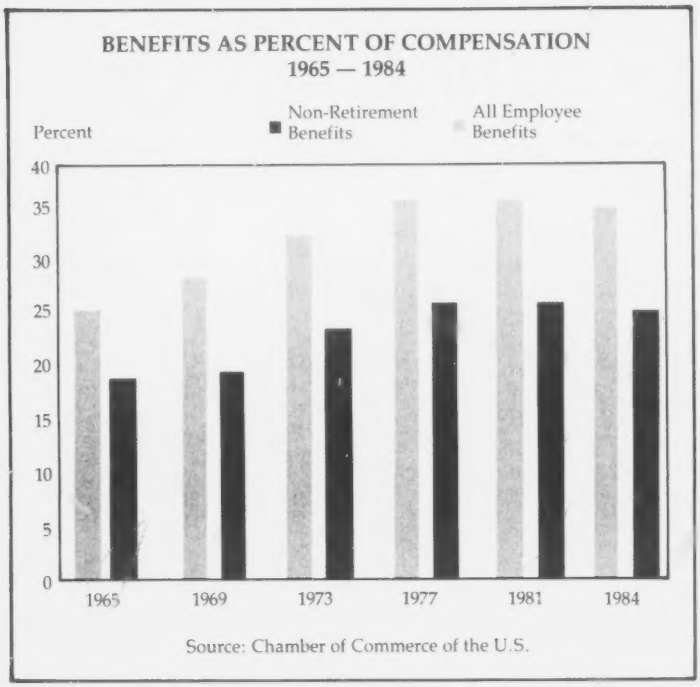
Additionally, the CEOs believe that employers need to work on two fronts to control medical costs: health promotion, wellness and preventive-care programs; and a partnership between government and the private sector to assure affordable medical care for all citizens.

As the result of several court decisions and the direction of the Financial Accounting Standards Board, one of the biggest potential problems facing employers is retiree medical benefits. The questions become, Can employers change them? Will they fund them? Must they report these benefits?

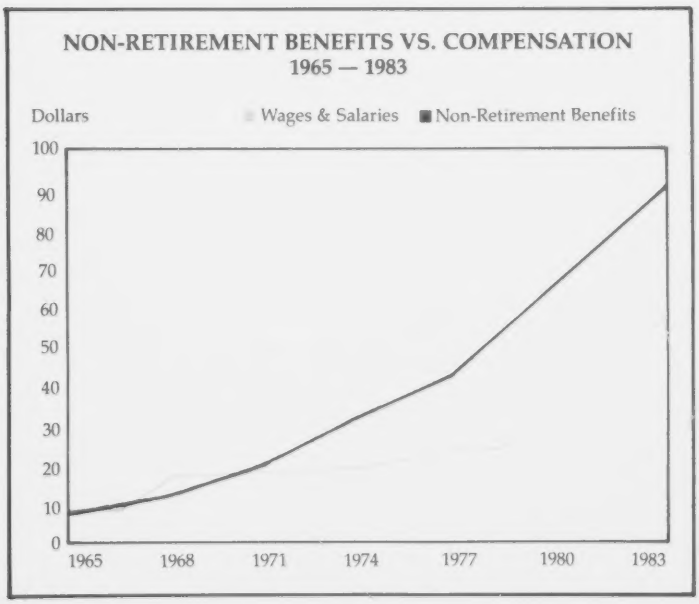
The combined effect of these various influences on non-retirement benefits is changing employers' philosophy from







Source: Chamber of Commerce of the U.S.



entitlement to compensation. In general, companies are shifting from defined-benefit plans to defined-contribution plans as they begin to focus on their benefit budget. Indeed, the question is less, What benefits can we provide? than, How much money will we allocate?

The requirements for effective, appropriate benefit design will force employers to track employee data and benefit utilization more carefully and systematically in the future. And emphasis on individual responsibility will require a more enlightened employee-communications strategy. As a result, health-care consumers must be educated in order to become wise buyers.

Because of these changes in philosophy, employees will be asked to share more of the benefit costs. Employees may be ready for this change. Many large corporations have tightened the budget belt in ways that undeniably get attention; eliminating vision and hearing-care plans, suspending special vacation benefits, and modifying overall health-care programs to make employees more aware and responsible.

By having a greater responsibility for cost, more employees will be allowed to customize their benefits package—either through more options or some form of benefit flexibility. Employee surveys conducted after the implementation of flexible-benefits programs indicate an increase in employee appreciation and satisfaction with their benefits.

Total compensation, and the benefits' share of it, is related to productivity as well. Economic reasons, including rising investments, better technology, more schooling and the potential in international trade, lead to thoughts that productivity in the United States is on the rise. If this is the case, it will mean an upward trend in compensation per employee. But whether that brings a further increase in benefits remains to be seen.

While economics dictates benefit philosophy, emerging tax provisions will continue to exert pressure to maintain, if not increase, the share of earnings paid in benefits.

Overall, the economy is a kaleidoscope—an ever-changing mix of variables: inflation, taxation, unemployment, demographics, legislation and judicial decisions. Although benefit programs cannot control economic factors, they can be designed to respond to them effectively. The designers of non-retirement benefit programs must be acutely aware of these influences and of program objectives to ensure that what they intend does in fact take place. □

High-Yield Bonds Achieve Legitimacy As A Pension Investment

High-yield securities have become an accepted means of rounding out investment portfolios without seriously endangering the safety of principal.

BY GEORGE KLEIN, Principal and Fixed-Income Portfolio Manager
Kemper Asset Management Co., Chicago

It is no secret that high-yield securities can be a risky investment. Indeed, the term "junk bond" recently has been used to symbolize the high-yield, low-grade segment of the bond market. Yet, high-yield bonds have become a legitimate means of rounding out investment portfolios without seriously endangering the safety of principal.

Moreover, many companies are now amenable to having portfolio managers invest in high-yield securities for their pension portfolios. And these high-yield investments are allowing firms to benefit from additional income without jeopardizing long-term pension needs.

Overall, the issuance of high-yield bonds has increased nearly 280 percent since 1985. The size of the high-yield market—$165 billion or nearly 30 percent of all outstanding corporate bonds—dictates that high-yield securities no longer can be ignored. These bonds have become a way of doing business for corporate America.

In the first six months of 1988, the high-yield sector had the highest return among U.S. fixed-income securities, returning 8.2 percent. The investment return was nearly double the return on U.S. government securities during that period and at least 200 basis points more than high-grade corporate bonds and current coupon-mortgage securities.

Additionally, during the past five years, high-yield securities have outperformed the Shearson Lehman Government Corporate Index by approximately 300 basis points.

In addition, investors are encouraged by the increased liquidity of these securities as more Wall Street firms become involved in trading high-yield bonds.

Economic shifts

When putting together a portfolio that includes high-yield bonds, flexibility is of the utmost importance. Without flexibility, long-term investment objectives can be at risk when economic shifts occur.

While other securities in a bond portfolio are driven by interest-rate changes, high-yield bonds—some of which yield 400 to 500 basis points above U.S. treasury bonds—are more dependent on credit developments. As a result, high-yield bonds can provide a cushion against day-to-day or even quarter-to-quarter interest-rate movements. Not only does this give portfolio managers considerable flexibility, it can actually decrease portfolio volatility while increasing income.

By incorporating high-yield bonds into a discretionary portfolio, managers are able to use their closeness to the market to decide when it may be appropriate to be involved with high-yield issues.

To capture the largest benefits offered by high-yield bonds, portfolio managers generally should purchase these securities during the recovery period of an economic cycle and sell them as the economy moves toward a recession.

Generally, the opposite approach should be taken with government securities. Using this strategy, after an in-

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crease in interest rates, managers can sell their high-yield holdings and purchase high-grade securities. This allows them to get back to the same position that managers of high-grade securities held all along—at a cheaper price and with additional income from the high-yield securities just sold.

Core position

How does a portfolio manager decide which securities to invest in? In a discretionary portfolio, it is important to maintain a core position of investment-grade issues and select high-yield investments that can be controlled by solid research and comprehensive credit analysis.

In most instances, research and analysis must go beyond looking at corporate balance sheets. Attention must be paid to a company's debt schedule and fixed costs, the firm's cash-generating capability and its competitive position within the industry. And all these factors must be taken in the context of an industry's position in the business cycle.

Portfolio managers must be selective in the high-yield area. This selectivity involves investing in more liquid issues, typically more than $100 million in size, and in industries that are showing strength, such as container and cable businesses in the current market.

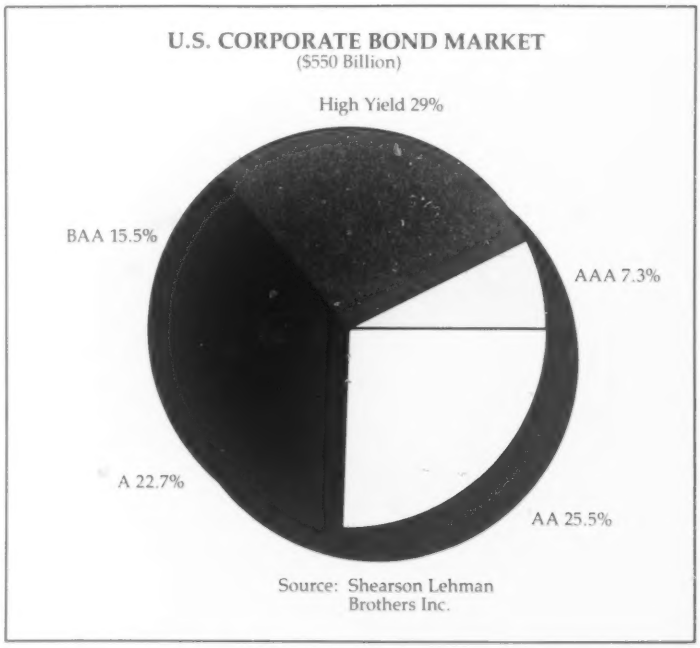
Risk also can be further controlled by industry and issue diversification. Limiting purchases of a single security to no more than 5 percent of the portfolio value is good discipline.

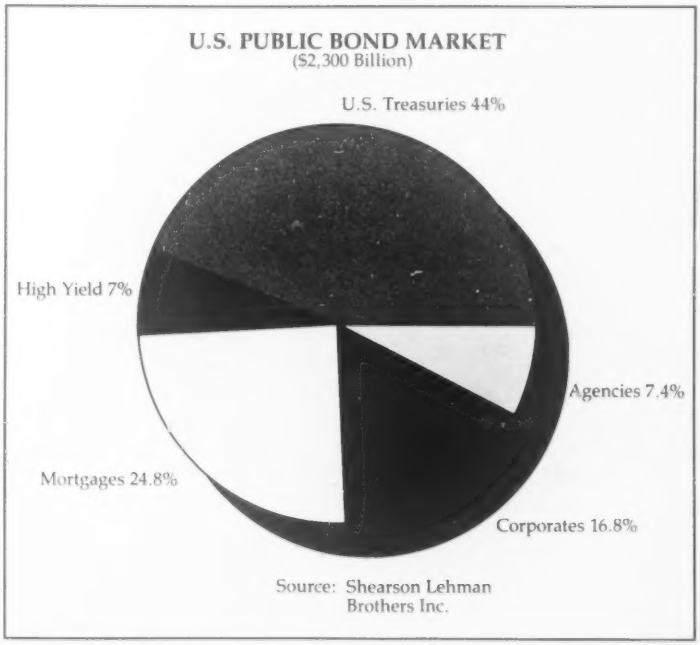
Simple as possible

Additionally, a portfolio of high-yield securities should be kept as simple as possible. Credit risk and maturity should be clearly defined, and complex mortgage-backed issues, as well as high-yield bonds with uncertain put-option and call-option risks, should be avoided.

Moreover, portfolio managers must be aware of economic shifts that could affect the high-yield market. They must also keep close tabs on individual securities. By combining high-yield and high-grade securities into a single portfolio, managers have the flexibility to move from one asset class to another, especially during changes in the economy. And if a high-yield security appears to be faltering, it may be best to sell that security immediately.

By keeping investments simple and making a commitment to solid research, high-yield securities can be expected to continue to play a profitable role in long-term pension investing. □





Bankruptcies Provide New Opportunities

BY WILBUR L. ROSS JR.
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When Texaco filed for bankruptcy on April 12, 1987, the California and Pennsylvania Public Employees Retirement Systems, two of the nation's largest pension funds, began to make history along with the Texaco case. In fact, the funds helped settle the Texaco-Pennzoil litigation by convincing Texaco management to broaden shareholders' decision-making powers and worked to provide pension funds with access to Texaco's director-nominating process.

In doing so, the two pension funds crystalized a radical change that quietly has been taking place in institutional shareholding: Pension funds are assuming a critical role in shaping corporate-governance policy.

Taking control

Today, pension funds are less willing to be passive investors and to let their investment managers vote routinely in favor of management on corporate-governance issues. Pension funds are taking control of their votes and using their considerable influence to maximize shareholder value.

One way pension funds are doing this is by acting as the swing vote in proxy fights, such as the one that took place when Coniston Partners unsuccessfully attempted to take control of Gillette.

Another is by initiating proxy fights over the critical issue of shareholder democracy. In such fights, pension funds often have been backed by the Council of Institutional Investors. This happened during the recent annual meetings of Honeywell, Upjohn, Phelps Dodge and several other large companies.

But the pension funds' newest weapon is the equity committee appointed in each major Chapter 11 bankruptcy case.

Increasingly, Chapter 11 has become an important corporate finance tool. The strategy has been used when a company's basic business is viable, but liability for a specific product or action requires extraordinary protective measures. The equity committee, in turn, has become the focal point of activity for the financial restructuring.

Equity committees usually comprise the seven holders of the most equity who are willing to serve. Typically, a committee arms itself, at the bankrupt company's expense, with lawyers, investment bankers and accountants. These professionals guide a committee through the legal and financial issues, analyze information, outline and recommend courses of action, and implement committee decisions.

Due to their official status and the support of their advisors, equity committees can function as shadow boards, formulating positions on all key issues, including management and board composition of the reorganized company, the resulting capital structure and what businesses or assets should be divested.

The equity committee in the Texaco case concluded that management might try to escape the $11 billion Pennzoil judgment by appealing to the U.S. Supreme Court. Upon analysis of the probability that the decision would be overturned and the financial implications if it was not, the committee concluded that a $3 billion settlement was preferable to "betting the ranch."

The committee's chairman and his advisors met privately with Pennzoil and negotiated the $3 billion settlement, which ultimately was accepted by the creditors and Texaco. The committee, with the significant and unique contributions made by the California and Pennsylvania retirement funds, also convinced Texaco's board of directors to remove certain obstacles that were severely limiting shareholder rights and to adopt an anti-greenmail resolution.

Ultimately, Texaco not only agreed to endorse the committee's position on the issues but also to finance more than $1 million in proxy solicitation expenses related to the committee's efforts to win shareholder votes. Both actions were unprecedented for U.S. corporations.

Equity-committee influence

An equity committee's bold actions can enhance stock prices. Indeed, The Charter Co. made several divestitures and arranged for another company to fund the plan of reorganization by purchasing control. And by working with an outside firm to find a competing bidder, the stock price was driven up.

In the Revere Copper & Brass Co. case, analysis showed that the liquidating value of the company was substantially greater than the market price. Therefore, the equity committee successfully insisted that any stock issued in satisfaction of debt should be at a large premium over the market price. Six months after confirmation, Revere was sold at a price above its highest price during the past 10 years.

In the case of A.H. Robins, management wanted to leverage the company to the hilt to pay the Dalkon Shield claims and re-emerge as an independently traded company. However, the equity committee decided to maximize values by selling Robins to a major pharmaceutical company that would benefit both from operating synergies and from the tax credits created by the $2.5 billion Dalkon payment. When management filed its plan with the Supreme Court, the equity committee announced that it opposed

HOW EQUITY COMMITTEES HELPED STOCKHOLDERS ACHIEVE HIGH RATES OF RETURN DURING BANKRUPTCIES

	Price at start of bankruptcy	Price at end of bankruptcy	% Gain	Case Duration	Compound Annual % Return
The Charter Co.	$2.50	$4.00	60%	2.66 yrs.	19%
Revere Copper & Brass Co.	4.875	13.625	179	2.75	45
A.H. Robins Co.*	5.50	25.75	368	2.92	45
Salant Corp.	3.875	11.25	190	2.25	61
Texaco Inc.	27.375	47.25	73	1.00	73

Source: Rothschild Inc.

*Appeal pending.

the proposal and would conduct its own auction of the company. Two weeks later, American Home Products won the bidding and paid the stockholders $200 million more than management's proposal.

And in the Salant Corp. case, the equity committee convinced creditors to exchange debt for equity at a substantial premium over the market price and to provide lenient covenants on the surviving long-term bonds. Less than a year after confirmation, Salant was strong enough to acquire Manhattan Industries.

Corporate governance also was substantially improved in the Texaco bankruptcy, where the California and Pennsylvania retirement funds were actually represented on the equity committee. In the case of Robins, two institutional investors informally supported the committee, and the Belzberg interests were represented on the Revere committee.

Pension participation

Since committee participation can create such important economic and shareholder democratization benefits, why aren't more pension funds on committees? There are several answers.

One reason is that many institutions worry that insider information inherent in committee membership might preclude trading because no safe-harbor rules have been promulgated by the Securities and Exchange Commission (SEC). In attempting to deal with this problem, the Council of Institutional Investors met with senior SEC staff members who agreed to recommend to the full committee that Rule 14e-3 be extended to Chapter 11 committees.

This rule provides that a "Chinese Wall" between the party possessing inside information and the investment decision-makers will permit continuation of normal investment decision-making. This is a major breakthrough and is expected to eliminate the largest single barrier to institutional membership. Even before issuance of the release, many money managers will be comforted by knowledge of the staff's informal position.

Several factors mitigate the exposure. First, there is a protection inherent in the fact that all committee actions are part of a court proceeding. Second, in any major decision, a committee relies on the recommendations of advisors. And third, while committees have tremendous practical power, they cannot bind their constituents on major issues such as the terms of a plan for reorganization.

A plan normally requires the affirmative vote of the holders of two-thirds of the voting stock. The committee merely makes a recommendation. Also, a committee's counsel would defend members against any litigation arising from official committee activities. The consensual plans of reorganization typically absolve members from liability for their actions in the proceedings. For these reasons, fear of litigation usually is unfounded.

One unique problem

Yet, public pension funds do have one unique problem. The Bankruptcy Code limits committee membership to individuals. Governmental entities are excluded. The original purpose was to keep taxing authorities off committees, because they already have special status under the Bankruptcy Code. But nothing in the legislative history indicates that public pension funds were intended as targets.

In the Texaco case, Judge Howard Schwartzberg ruled that the California and Pennsylvania funds could serve as ex-officio or non-voting members of the equity committee. They did serve—with great influence and distinction. However, ex-officio status has been denied to the Pennsylvania fund by the U.S. Trustee in the Allegheny International case.

Somewhat at odds with the Allegheny case, in the Public Service of New Hampshire bankruptcy, an investment advisory firm with public-employee pension-fund accounts has become a full voting member of the committee. While this precedent might provide a means for achieving at least indirect participation even before legislative relief is attained, currently ex-officio status may be all that is directly available to public pension funds.

To clarify matters, the Council of Institutional Investors is crafting language that would redefine "person" to include public pension funds for inclusion in a pending legislative initiative regarding Chapter 9—the municipal bankruptcy section.

Once funds have exercised shadow-board powers in Chapter 11 proceedings, there is no conceptual reason why funds should not become principal participants in the takeover battles now being fought. Why shouldn't a pension fund make strategic investments, either in direct support of a takeover bid, in support of a defensive restructuring or a management leveraged buyout? In many cases, such intervention would not only make economic sense but also social and political sense. The barriers are a mind-set, organization and perception. All the barriers can be dealt with, and all can change. □

Wilbur L. Ross Jr. is senior managing director of New York-based Rothschild Inc., where he is responsible for the corporate finance department. Mr. Ross has advised the equity or creditor committees of Allis-Chalmers, The Charter Co., Continental Airlines, Public Service of New Hampshire, Revere Copper & Brass Co., A.H. Robins and Texaco. He is a graduate of Yale and Harvard Business School.